A8825-2

FOREIGN ACTIVITY

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

March 27, 1991

1990: The Year That Wasn't

The first year of the new decade saw U.S. and foreign investors in agreement on at least one thing: non-U.S. securities were a better investment than U.S securities in 1990. Accordingly, U.S. investors made net purchases of nearly $31 billion in foreign securities while foreign investors made net acquisitions of U.S. securities totalling $23.2 billion. (Of the foreign inflow, $24.1 billion was accounted for by central bank purchases of U.S. treasury notes and bond.) The result is sobering; for the first time since 1974, the U.S. suffered a net portfolio outflow, with U.S. securities prices suffering from the decreased demand.

1990 Foreign Flows Into The U.S.:
The Year That Wasn't
($Bils.)

	1990	*1989*	*Net Change*
Equities	(15.3)	9.9	(25.2)
Treasuries	19.8	54.2	(34.4)
-Private	*(4.3)*	*27.4*	*(31.7)*
-Public	*24.1*	*26.8*	*(2.7)*
Agencies	6.5	15.1	(8.6)
Corp. Bonds	12.2	18.9	(6.7)
Total Portfolio	23.2	98.1	(74.9)
Total Direct	25.7	72.2	(46.5)
Total All	48.9	170.3	(121.4)

This sharp reversal in the foreign investors' posture is all the more stunning given that they made net purchases of U.S. equity and debt securities totalling $500

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billion in the 1980s, supporting U.S. equity prices and supplying much needed funds to the U.S. fixed-income markets. As noted in the previous table, net acquisitions of U.S. securities were only $23.2 billion in 1990, down by over four-fold from last year's record $98.1 billion, and the lowest level since 1983. The coldest shoulder was shrugged at the U.S. equity market, where net *sales* by foreigners reached a record $15.3 billion. Foreign interest in U.S. fixed-income instruments was also chilled as net purchases equalled $38.5 billion, down from $88.2 billion in 1989.

The previous table underscores an important element of foreign investor participation in the U.S. markets in 1990. Central banks were the only foreign investors that acquired U.S. securities, with foreign exchange intervention as their goal. They added to their holdings of U.S. securities by acquiring $24.1 billion of U.S. treasuries. On the other hand, foreign private investors actually made net sales of U.S. securities for the first time in over a decade. Acquisitions of U.S. fixed-income securities totalled about $14.4 billion, coupled with record net U.S. equity sales of $15.3 billion, resulted in an outflow of capital near $1 billion. Private investor decisions are motivated by returns on their U.S. investments relative to other opportunities. So, in a broad sense, they are an indicator of the future course of the U.S. economy relative to that of other nations. In addition, increased worldwide demands on capital serve to bring home, in a powerful way, that the U.S. can no longer expect a steady stream of foreign capital.

Foreign Activity In U.S. Equities

GROSS TRANSACTIONS IN AND NET PURCHASES OF
U.S. EQUITIES BY FOREIGN INVESTORS
($Mils.)

	FULL YEAR 1989		FULL YEAR 1990		
	GROSS ACTIVITY	NET PURCHASES	GROSS ACTIVITY	NET PURCHASES	% CHANGE IN GA FY90-FY89
EUROPE	**$203,790**	**$1,010**	**$174,833**	**($8,579)**	**(14.2%)**
BELGIUM-LUXEMBOURG	14,044	346	12,992	(736)	(7.5%)
FRANCE	15,620	95	12,826	(1,183)	(17.9%)
GERMANY	15,747	(592)	12,160	(370)	(22.8%)
NETHERLANDS	7,387	6	6,122	(407)	(17.1%)
SWITZERLAND	32,934	(3,483)	27,845	(2,884)	(15.5%)
UNITED KINGDOM	97,217	4,507	92,880	(3,122)	(4.5%)
CANADA	**45,397**	**(867)**	**37,678**	**890**	**(17.0%)**
LATIN AMERICA & CARIBBEAN	**61,343**	**3,049**	**50,718**	**(1,347)**	**(17.3%)**
BERMUDA	12,701	1,329	11,082	(128)	(12.7%)
NETHERLANDS ANTILLES	18,568	744	16,521	(1,072)	(11.0%)
ASIA	**97,974**	**6,869**	**85,340**	**(5,952)**	**(12.9%)**
HONG KONG	9,021	139	9,041	(323)	0.2%
JAPAN	60,769	3,255	58,152	(2,907)	(4.3%)
OIL EXPORTING COUNTRIES	23,899	3,591	13,892	(2,447)	(41.9%)
TOTAL ALL COUNTRIES*	**$418,175**	**$9,946**	**$361,371**	**($15,301)**	**(13.6%)**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Foreign investors made net purchases of nearly $65 billion in U.S. equities during the 1980s. Combined with rising U.S equity prices in the 1980s, they upped their holdings of U.S. equities from $48.3 billion at the beginning of the 1980s to $257.4 billion at the end (equivalent to about 6.7% of equities outstanding) . Indeed, their appetite for U.S. equities was such in the 1980s that they were one of the largest positive influences on U.S. equity prices. The first year of the new decade showed a sharp reversal in the foreign investors' posture, with net sales totalling a record $15.3 billion and a reduction in holdings to $218.4 billion. Activity levels were also off sharply with transactions down to $361.4 billion in 1990, 13.6% less than 1989's $418.8 billion. While the size of the sell-off was unexpected, the factors which lead to it are fairly clear. Political and economic factors outside of the U.S., the increased demand for capital, higher interest rates, turmoil in the Japanese market and German reunification, just to name a few, made U.S. equities less appealing. Factors in the U.S., including federal budget gridlock, a declining dollar, and sinking U.S. equity prices, simply made the foreign investors' decision to leave the U.S. all the easier.

While the U.S. was a star performer compared to foreign markets in 1990, the downward path of the U.S. dollar was cause for concern for investors. True enough, the dollar on average only declined about 8%, but since its peak in 1985 it has declined about 32%, leaving foreign investors with substantial currency losses. Moreover, relative to the Yen, the dollar has declined over 39% and a near 45% devaluation against the deutschemark. The multi-year decline of the dollar, and its negative impact on the foreign investor's return on U.S. equities, helps explain the ferocity of the 1990s sell-off. This is particularly true of Japanese investors who were making record U.S securities purchases during this period. Indeed, we may not see sustained U.S. equity commitments by foreign investors until the U.S. greenback performs well, or at least shows some stability over some period of time. The current rise in the dollar, though disturbingly sharp, may be such a sign.

The sell-off was so complete that none of the countries analyzed in *FAR* made net purchases. Indeed, investors from France, Switzerland and the U.K. made net sales in each quarter of 1990. Japanese investors, beset by higher domestic interest rates and crumbling equity prices, divested $2.9 billion. As recently as 1987, these investors made net purchases of $11.7 billion.

OPEC members, 1989's largest acquirers of U.S. equities, made net sales of $2.4 billion in 1990. These investors had been steady sellers through the first three quarters of 1990, divesting $1.2 billion. The onset of hostilities in this part of the world in August 1990, and promises from various OPEC members to help fund the U.S. led coalition's efforts against Iraq, seems to have led to sales of U.S. equities. The future commitments which will have to now be made by these countries to help finance the rebuilding of Kuwait's infrastructure may lead to reduced equity investment by these countries in the future.

Foreign Participation In The U.S. Treasury Market

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. TREASURY NOTES AND BONDS BY FOREIGN INVESTORS
($Mils.)

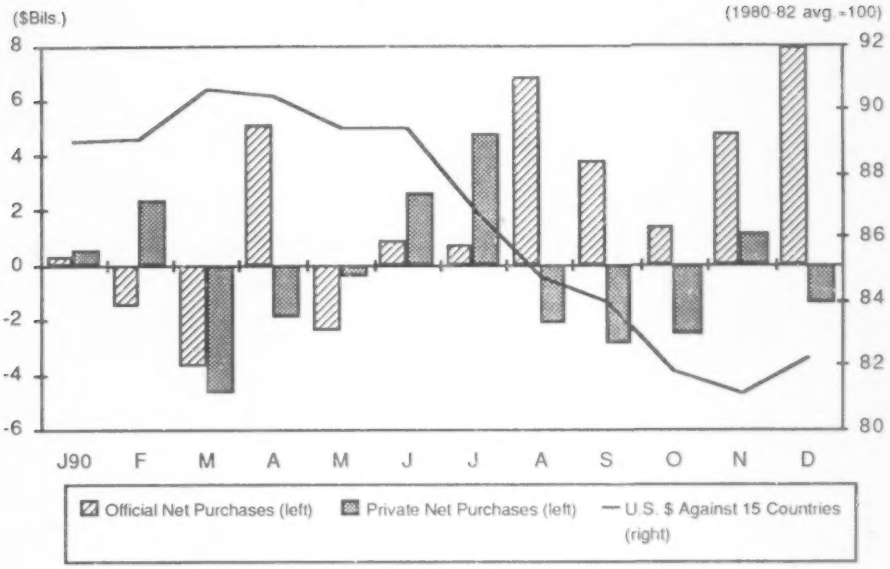
	FULL YEAR 1989		FULL YEAR 1990		
	GROSS ACTIVITY	NET PURCHASES	GROSS ACTIVITY	NET PURCHASES	% CHANGE IN GA FY90-FY89
EUROPE	**$1,557,058**	**$36,286**	**$1,507,211**	**$18,791**	**(3.2%)**
GERMANY	57,199	7,904	82,032	5,750	43.4%
SWITZERLAND	30,047	1,098	31,558	146	5.0%
UNITED KINGDOM	1,106,140	20,198	1,057,329	(2,159)	(4.4%)
ASIA	**2,198,065**	**13,297**	**1,808,611**	**(11,064)**	**(17.7%)**
JAPAN	1,886,989	1,681	1,552,619	(14,881)	(17.7%)
OIL EXPORTING COUNTRIES	115,288	8,148	78,464	(383)	(31.9%)
NONMONETARY INT'L & REGIONAL ORG'S	**148,045**	**1,902**	**211,203**	**(354)**	**42.7%**
TOTAL ALL COUNTRIES	**$4,140,362**	**$54,198**	**$3,634,604**	**$19,760**	**(12.2%)**

Source: U.S. Treasury

To discuss foreign activity in the U.S. treasury market during 1990, it is best to look at the substantially different postures taken by official institutions (central banks) and private investors. On the "positive" side, official institutions were net purchasers of U.S. treasuries totalling about $24.1 billion. This is in line with their average of $28.2 billion made during the period 1987-1989, when central banks attempted to give the rapidly declining greenback some support. Indeed, the graph below indicates that central bank net purchases in 1990 correlate closely with the dollar's decline.

On the other hand, foreign private investors made net divestitures of $4.3 billion, a dramatic about face from average net purchases of $28.2 billion made in 1987-1989. The dollar's decline, and more attractive foreign interest rates, laid the foundation for 1990's sell-off. Foreign private investors, looking to enhance their portfolios, decided that less was better than more in 1990.

Foreign Official And Private Participation
In The U.S. Treasury Market

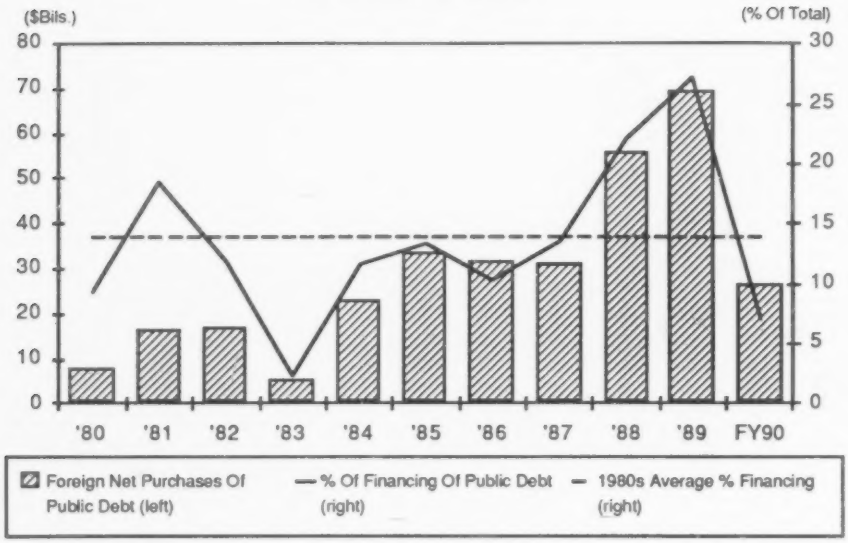


Japanese investors, by far, were the largest net sellers in 1990. Net sales totalled nearly $14.9, and left little doubt as to what the Japanese felt about U.S government securities. Increased yields on Japanese governments relative to those on U.S. issues, made U.S. bonds a poor choice. Significantly, Japanese investors made net sales of $7.6 billion in the fourth quarter alone. It may be speculation, but a portion of this selling may have been to raise dollars to help pay for America's role in the Gulf War. Indeed, a recent *Griggs & Santow Report* noted that foreigners have liquidated U.S. treasury investments to make war payments.

Other factors, including Japan's declining trade surplus with the U.S., increased opportunities in Europe and Latin America, and the tremendous build up of dollar-denominated assets in their portfolios since 1985, may continue to erode the levels of Japanese support in U.S.markets in general in the coming years. Underscoring the erosion in support were Japanese net sales of over $17 billion in U.S. securities in 1990. Since the signing of the Yen/Dollar Agreement in 1984, Japanese inflows had averaged about $20 billion per year through 1989.

We've updated the following chart (previously in our 2Q90 issue) because we believe it is instructive as to the impact of the reduction in foreign interest in the U.S. public debt market. Foreign net acquisitions of U.S. public debt (including both treasuries and agencies) totalled $26.3 billion in 1990, accounting for only 7% of the U.S. federal government's financing needs. This is well below the previous two years, and is half the 1980's average.

Foreign Support (Or Lack Of) In The U.S. Public Debt Market



This means that the U.S. was increasingly reliant on its own domestic funds to support deficit financing in 1990, draining domestic savings from equity markets to the debt markets. With increasing federal, state and local deficits ahead, and a low (and even decreasing) national savings rate, it may be that higher taxes, higher interest rates, or a combination, may be an unwelcome byproduct of the diminished foreign appetite for U.S. government securities. Either way, it seems that this scenario could result in constraints on future economic growth and expansion. Alternatively, a serious effort to cut government spending, along with increased savings, may prove more prudent.

U.S. Participation In Foreign Securities

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($Mils.)

	FULL YEAR 1989		FULL YEAR 1990		
	GROSS ACTIVITY	NET PURCHASES	GROSS ACTIVITY	NET PURCHASES	% CHANGE IN GA FY90-FY89
EUROPE	**$127,890**	**$10,096**	**$151,640**	**$3,424**	**18.6%**
EUROPEAN COMMUNITY	*$117,373*	*$8,001*	*$139,484*	*$3,796*	18.8%
BELGIUM/LUXEMBOURG	2,066	110	2,468	178	19.5%
DENMARK	525	37	653	117	24.4%
FRANCE	7,971	1,937	11,874	(162)	49.0%
GERMANY	6,891	373	14,109	725	104.7%
GREECE	18	6	55	9	205.6%
IRELAND	478	238	233	109	(51.3%)
ITALY	5,690	(456)	7,428	820	30.5%
NETHERLANDS	6,933	1,295	7,924	764	14.3%
PORTUGAL	66	56	70	36	6.1%
SPAIN	6,653	(629)	4,945	873	(25.7%)
UNITED KINGDOM	80,082	5,034	89,725	331	12.0%
SWITZERLAND	8,469	1,933	8,861	(565)	4.6%
CANADA	**10,870**	**1,278**	**9,636**	**96**	**(11.4%)**
LATIN AMERICA & CARIBBEAN	**9,296**	**360**	**9,887**	**1,937**	**6.4%**
MEXICO	315	7	2,005	909	536.5%
ASIA	**75,775**	**555**	**74,434**	**1,794**	**(1.8%)**
JAPAN	65,804	756	62,353	613	(5.2%)
OTHER	**8,844**	**808**	**13,732**	**1,146**	**55.3%**
TOTAL ALL COUNTRIES*	**$232,675**	**$13,097**	**$252,476**	**$8,407**	**8.5%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

U.S. interest in foreign securities reached record heights in 1990. Net acquisitions of all foreign securities totalled $30.8 billion in 1990, up from the previous year's $19.1 billion. The asset mix was sharply different, though. Consistent with the higher interest rate, lower equity price environment, the table below indicates the shift toward fixed-income instruments in 1990, with record acquisitions of $22.4 billion. On the other hand, net purchases of equities fell to $8.4 billion from 1989's record $13.1 billion. Even though, we should note, U.S. net acquisitions of foreign equities in 1990 were still the second highest level ever. Declining world equity prices dropped U.S. holdings of foreign equities from $95.8 billion in 1989 to $90.5 billion.

Performance Of Major Securities Market Indicators In 1990

	Equity Return (local terms)	*Long Bond*** (end period)	*Dollar Movement** (year avg.)
U.S.	-6.8%	8.1%	N/A
U.K.	-12.8%	11.2%	-9.1%
Canada	-14.4%	10.3%	-0.8%
Germany	-20.1%	9.0%	-13.8%
Switzerland	-21.8%	6.7%	-15.2%
France	-25.7%	10.0%	-14.7%
Japan	-40.4%	7.1%	4.9%

*Calendar Year Average
**End Period

Source: FT-Actuaries World Indices; Goldman Sachs International Limited

We also note that U.S. direct investment, at $36.4 billion, is also a record. And, for the first time since 1980, U.S. direct investment in foreign markets exceeded foreign direct investment in the U.S. The significant capital outflows in the past two years suggest that U.S. investors are increasingly sanguine about the growth opportunities in foreign markets.

U.S. Net Purchases Of Foreign Financial Assets
($Bils.)

	1990	*1989*
Equities	$8.4	$13.1
Debt	22.4	6.0
Direct Investment	36.4	31.7
Total	$67.2	$50.8

Turnover in both fixed-income and equity securities reached records. U.S. transactions in foreign bonds, a record $649.5 billion, was up 36.9% over 1989's $474.5 billion. The lure of strengthening foreign currencies and high overseas bond yields served to attract U.S. investment in foreign markets at a record clip. In foreign equities, transactions totalled $252.5 billion, up 8.5% over the previous year's $232.7 billion.

In 1990, we noted the U.S. investor's increased willingness to commit capital to less traditional markets. The prize of this class has been Mexico, where U.S. investors

committed over $900 million to Mexican equities, larger than any other country covered in *FAR*. The money was well committed; returns on Mexican equities totalled 79.6% in U.S. dollar terms. In addition, $343 million was placed in Mexican fixed-income instruments. The Salinas government's economic reforms, which include the opening of the Mexican securities markets to foreign parties, seems to be having its intended impact. Indeed, as a bonus, flight capital seems to be returning. Using U.S. bank liabilities to Mexican private investors as a proxy, we note that liabilities have dropped from a peak of $12.6 billion at 12/31/88 to $9.7 billion at the end of 1990, a decline of 23%.

U.S. investors seemed to attach almost equal importance to Spanish equities, where acquisitions reached $873 million. While the Spanish market dropped 14% in U.S. dollar terms during 1990, increased M&A activity, and a continuation of stepped up efforts to diversify into European stocks, may have helped to attract U.S. investment.

The last two years have sent a clear signal that U.S. investors are becoming major players in world securities markets. Economic and political reforms being implemented in Europe, Asia and Latin America should open U.S. investors, and "foreign" investors, to entire new areas of opportunity. In this "new world order", the U.S. will compete for both domestic and foreign capital.

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